Prospects for Growth in Japan in the 21st Century

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PREFACE

The Commerce Department's "Big Emerging Markets" program has focused the attention of U.S. exporters on the nations and regions that will provide the preponderance of demand growth in the decades ahead. Unsurprisingly, the economies of the Asian Rim dominate this list. But, there is another big emerging market in Asia, one that has massive potential for U.S. exporters in the long run.

That market is Japan. The structural opening of Japan's economy is inevitable, and when it happens, not only will U.S. exports find a new and welcome home, but then and only then will Japan's economy finally find the basis for the new and sustained round of growth that has eluded it in this decade.

This paper explains why.

Japan's ascension in the 1980's was taken as the logical result of our own economy's structural faults and the supremacy of the new Asian model, one proclaimed wholly and irreconcilably different from our own. But in the fewest and shortest of years, the tables have turned. The U.S. is now unarguably the leading economic region of the world. Japan's economy has ground to a halt, plagued by asset write-offs, industrial overcapacity, and a form of economic organization rooted in a bygone technological age.

Part of Japan's economic stagnation is attributable to the "post-bubble" economy, a story that has been well chronicled. But the Japanese economy's recent performance is also caught up in the ongoing advance of digital technology and the Information Revolution.

This new Revolution has overhauled our ideas about what it means to be in business. Cheap data processing and telecommunications now allow separate firms to coordinate their activities as effectively as can a vertically chained firm. The Information Revolution, therefore, is shrinking the large organizations that the Industrial Revolution built.

This new ability to build "plug and play" value chains -- so-called "virtual companies" -- is important. Firms everywhere are undergoing a new wave of specialization and "dis-integration." They are redefining themselves around sustainable value-creating skills in specific activities or segments of the value chain. They are turning to the market to complement those skills with a technology, a component, a complementary product, or access to a market segment through joint ventures, partnerships, alliances, simple transactions, or other relationships.

While there are limits to this process, this is the model that business will be compelled to follow. In an economy in which each competitor offers some world-class ability, the successful firm will be one that takes what the market offers and adds value to it. Thus, the ongoing repositioning of a firm's boundaries is a basic competitive maneuver in the Information Age.

This is exactly what Japanese firms are not good at doing. The *keiretsu* system is not designed to create or support the openness that allows firms to lever this higher level of specialization. Instead, it creates a walled city that shuts its members in from outside distraction. However, it shuts them out from opportunity as well. Where once that system was a way of perfecting the use of information within vertical structures, today it seals off its members from the abundance of "horizontal" information available worldwide.

Fifteen years ago, Japanese business organizations looked like world beaters because they had learned how to make vertical information flows work. American business looked bloated and lethargic. The U.S. system of contestable corporate governance was seen as deficient, preoccupied with short-sighted financial engineering. Today, these perceptions have been reversed. American business seems adaptive and quick to master new conditions: Japanese business is coming to look oversized and sclerotic by comparison.

All of these generalizations, of course, overstate the reality from which they are drawn. But the truths they embody reflect an epochal change in the technological underpinnings of the economy. The Information Revolution is fundamentally changing both the U.S.' and Japan's prospects by interacting with the business system, culture, and forms of organization of each. The American business "system" -- from its culture of entrepreneurship to its rules regarding corporate governance -- is favored by this technological revolution. The Japanese system is not.

If all of this true, then how can Japan be Asia's surprise growth market? In fact, one statement logically follows from the other. The restructuring of global business will compel Japan to become a more open economy if it wishes to grow again.

Consider what one might do to spark growth in Japan. Let me suggest four growth policies, all of which will be familiar.

The first would be to reform dramatically the regulations that dominate Japan's retail and distribution activities. These have been structured as an afterthought to production, rather than as competitive, value-creating activities in their own right. The result is that Japanese consumers pay far in excess of world market prices for most things.

This is not just a source of woeful welfare loss for the Japanese. It is an important macroeconomic phenomenon as well. Western economists have long searched for the origins of the very high Japanese saving rate, from cultural predispositions to government policies. Let me suggest another and important one: the Japanese save so much because things cost so much. If imports were given free reign and world market prices permeated Japan as a result, the ensuing one-time deflationary shift would increase the real value of those savings and decrease the desire

to hold them. The result would be an outburst of domestic demand capable of maintaining growth.

Look at the success already enjoyed by Japan's few pioneering discount stores. Imagine an entire economy that operated that way! Actually, you do not need to imagine it -- all you need to do is look out the window at our own.

A second growth policy would reform Japan's land use patterns and construction industry.

- Japan's land use patterns have often been criticized -- "sunshine" laws prohibit building "up," while the grand fathering of agricultural uses prohibits rational location patterns. There are often reasons for these patterns that Westerners miss. A society as old as Japan's, for example, will have religious sites (perhaps from previous millennia) that defy the bulldozer. Deeds go back for generations. The risk of earthquakes poses an ongoing concern. But the fact remains that barriers to efficient land use now actively restrain growth.

- A built-up Tokyo would revitalize Japan's construction industry. Taller buildings in better places would bolster land prices. Larger homes would allow the Japanese to buy more goods: at least there would be someplace to put things when you brought them home. Again, the result is growth.

A third and much-championed growth policy would be to reform and deregulate the financial system. The Japanese banking sector has been closed and closely (if apparently haphazardly) regulated in large part to protect the industrial firms with which the leading banks are associated. Today, the tables are turned, and the banks are the ones that need protecting. While deregulation would subject them to competitive pressure, it would also allow them to reallocate the economy's risk in a more efficient fashion. This is the best way to avoid a future "bubble" and its aftermath.

The Hashimoto government's new package seems to move in that direction. But, it remains to be seen where meaningful financial deregulation will lead. A competitive and open financial industry would support the process of unbundling old enterprises and creating new ones. It would facilitate entrepreneurship. It would provide the financing necessary to restructure companies. It would allow risks to be managed more efficiently by providing means to do so, which would allow smaller companies to compete more effectively. We will see how far down this road Japan will travel.

The fourth growth policy is to embrace openness, not just in trade, but in all economic activity. The notion of a closed economy -- nations as base camps from which to leap into world markets -- has passed. Japan's thinking about its economy shows signs of this outmodedness -- witness the failure of its recent Fifth Generation Computer Project attempt to develop systems that duplicated what the world already provided.

This openness must inevitably spread to corporate governance. Let me introduce a phrase into our discussion that seems in some sense revolutionary but will soon become commonplace -- ***outmoded and inefficient Japanese corporate organization.*** For reasons we have already discussed, these powerful, integrated, large organizations are threatened with the fate of the dinosaurs. Beyond offshore investment (hardly a radical idea), their response to date too often has been incremental -- fewer new hires, some revisions in compensation policy, perhaps some isolated lay-offs.

As product markets become more open and competitive, prices will come to reflect the specialization and efficiency of companies whose places in the market are won by world class skills rather than cross-holdings of shares. The squeeze on these integrated organizations will intensify. And this pressure will inevitably distinguish those elements of Japanese corporate integrated value-chains that stand up to economic scrutiny from those that do not.

And some will not -- comparisons of U.S. (Census Bureau) and Japanese micro data on plant productivity demonstrate that smaller U.S. suppliers in the auto-related industry, for example, are far more productive relative to the biggest firms than are their Japanese counterparts. It would be unsurprising to find this pattern elsewhere in the two economies. At some point, the technologically-compelled forces of "dis-integration" will have their way.

That is not to say that Japan's large companies will disappear. It does mean that they will be faced with pressure to undergo the process of boundary redefinition -- to wrap their organizations more tightly around a core of world-class skills -- just as their American counterparts are now doing. They will be led to search more widely for, and have a more competitive relationship with, their suppliers. They will require that each stage of their operations earns its own margin and uses its assets effectively.

U.S. firms came to this process early and successfully because of certain institutional assets -- stockholder rights, an active market for corporate control, a legal framework that allowed the transitions, capital markets that were liquid enough to finance them and open enough to let foreign firms compete for a fairly valued result. Japan lacks those institutions, but will either have to develop them or find some other way to make the transition. It happened to IBM. It will happen to Fujitsu.

So there are four growth policies -- reform of retail and distribution, land use and construction, and financial markets, and a greater "culture of openness." What is remarkable about this list is that they are all among the highest priorities of U.S. trade policy.

That is the point. We have too often thought of these policies as unilateral concessions we demand of the Japanese. It is time to think of them instead as tonics for what ails Japan, prescriptions for a new and now elusive expansion.

A growing segment of the Japanese business community is coming to understand these pressures. They see American firms, once prone to being dismissed, as suddenly leaping past them to embrace a new way of doing business. While they will not have to embrace the American model outright, they will have to assimilate many of its features. Most simply put: Japan will have to become more like "what we want them to be" in order to survive as a leading economy.

If that is the case, then there is the prospect of a vibrant and growing Japan, one that becomes more fully integrated into the world and more open to its trading partners.

This does not mean that the Untied States does not have important and pressing trade concerns that we must make clear to Japan. But, it does mean that our agenda means more than open trade -- it means economic growth. It also means that soon -- perhaps surprisingly soon, given the tempo of change that the Information Revolution has brought -- Japan will become the surprise growth market for American business in Asia.

Everett M. Ehrlich,
Under Secretary for Economic Affairs

EXECUTIVE SUMMARY

Japan pursued a highly successful growth strategy after World War II that was based on high levels of savings and externally driven growth. By funneling resources into export industries, Japan created in some respects a dual economy, with less efficient industries that supply domestic consumers, both private and public, along with a very competitive export sector. This strategy was supported by a variety of government policies, including maintenance of an undervalued currency, stable macroeconomic polices, incentives to save, targeted investment, restrictions on imports, and promotion of key traded sectors of the economy. Japan improved its domestic competitive environment to promote growth by initiating key economic reforms, such as land reform, antitrust measures, labor reform, and education reform. In addition, its *keiretsu* system of enterprise groups provided members with investment capital, risk sharing, and employee safety nets, in exchange for buyer-supplier loyalty and other limits on sales and financing flexibility.

However, reliance on past strategies of promoting export growth and protecting home markets is not likely to revitalize its currently stagnant economy, or promote longer term growth. The bursting of the financial bubble in 1990 that accompanied the expansionary monetary policy in the second half of the 1980s put Japan's economy in a long recession, out of which it has been slowly recovering. Although growth forecasts in the coming year look positive, its medium to longer-term outlook for growth appears less bright, given changes in the world market place and domestic trends.

Global economic integration and technological changes are altering the nature of world competition, and are presenting challenges to businesses and governments worldwide. These global changes have already led to major restructuring in U.S. firms and the U.S. economy during the past decade, and these same competitive forces can be expected to affect Japan and other countries, too. The restructuring of the U.S. economy appears to be paying off, in part because the openness of the U.S. economy not only forced U.S. firms to improve constantly their efficiency in order to compete in world markets, but also because its enhanced access to resources or skills from abroad, helped to raise productivity and reduce costs. The openness of the U.S. economy has become a competitive asset.

Japanese domestic trends are expected to lead to slower growth in the future than in the 1960s, 1970s, and 1980s. In the short-term, the bursting of the financial bubble resulted in an enormous bad debt problem in the banking sector, and this problem is expected to constrain domestic investment and growth in the near term. In the longer run, the expected decline in Japan's saving rate and labor force means slower economic growth and major shifts in the composition of aggregate demand and industry structure. Model simulations are used to estimate the possible magnitudes of the effects of these declines on growth.

Japan needs to raise the trend in its total factor productivity growth, which has been zero or near zero since 1980. To raise productivity growth, major structural changes are needed -- trade liberalization, deregulation, and corporate restructuring. These changes are made all the more imperative by the historically high yen exchange rate, which is reducing Japan's competitiveness.

Opening up Japan’s markets to foreign competition and reducing non-tariff trade barriers would improve efficiency and productivity, especially in non-exporting and protected sectors. Compared to other industries, productivity has grown in sectors (e.g., autos and semiconductors) that have been opened to trade through negotiations between Japan and the United States. Opening of other sectors is being negotiated.

Deregulation is an important component of market opening initiatives. A comparison of Japanese and U.S. productivity growth in individual industries shows a significant lag in Japanese industries that remain highly protected and/or regulated. These differentials point to sectors where productivity improvements might be gained through deregulation. A review of Japan's productivity growth in individual sectors shows that those industries facing highly competitive markets and fewer government regulations experienced higher productivity growth than those that have been high regulated and/or protected form external competition. A number of sectors -- in particular, real estate, financial services, retail and distribution -- are heavily regulated, and could achieve productivity gains with fewer government rules. In the telecommunications services industry, where deregulation has begun, albeit slowly, productivity is higher than that in countries (Germany, France, and the U.K.) that have been slower in deregulating this industry.

The potential for productivity gains is highlighted by the extent to which Japan’s industries are regulated. Regulated industries, most of which are in the agricultural and service sectors, account for an estimated 40 percent of Japan's GDP. Moreover, the United States provides a means of gauging what gains might be achievable. Regulated industries in the United States accounted for about 6.6 percent of U.S. GNP in 1988, down from 17 percent in 1977, because of regulatory reform. Regulatory reform, during this period, improved U.S. GNP an estimated 0.5 percent, and benefitted consumers, labor, and producers.

Along with deregulation, changes in corporate governance and restructuring are needed to improve productivity growth. Deregulation will add to existing pressures of the prolonged 1990s recession, the high yen, and rapid technology changes on the traditional Japanese corporate structure. Some Japanese corporations, especially those operating in relatively unregulated markets and facing world competition, have been taking steps to restructure -- moving production overseas, reducing dependence on *keiretsu* banks, loosening keiretsu ties, and developing new alliances. They have also begun changing employment practices, reducing new hires, cutting back on bonuses and raises, encouraging early retirement, and promoting younger workers above seniors. The practice of life-time employment, however, is expected to change slowly, and probably remain in some form because of social and cultural traditions. In contrast, corporations in regulated sectors of the economy have taken few steps to restructure, and are unlikely to do so.

Unless Japan seriously undertakes deregulation and corporate restructuring, it can expect to face reduced economic growth and limited flexibility for change in the longer term. Global competitive pressures are becoming increasingly powerful, and the long-term strengthening of the yen has reduced, and will continue to reduce, the competitiveness of Japanese exports. Japanese corporations, too, must earn at least market rates of return or close operations. Threats to their economic survival may force Japanese companies to break long-standing traditions and undertake painful steps, including layoffs. To the extent that deregulation opens the Japanese economy to external competition, U.S. firms and industry would be in a better position to enter and compete in Japanese markets.